



REINING IN THE FED'S FAILED AUTHORITY

The Federal Reserve (Fed) has incurred income losses since 2022 as interest owed on bank reserves mount, and it continues to cover up the losses through deceptive accounting practices. In doing so it undermines one of its core responsibilities to promote stability in the financial system. Congress can help restore confidence in the Fed's ability to credibly conduct sound monetary policy to support long-run economic growth in our nation by reining in the authority of the Fed and prohibit any funding transfers to separate government agencies that subvert Congressional appropriations.

BACKGROUND

- **Fed's balance sheet has increased over 9-fold since 2008**
 - The Fed's balance sheet has grown substantially over the past decade and a half, reaching a peak level in April 2022 at \$8.965 trillion.¹ This is 930 percent above the level in February 2008 prior to the collapse of several non-bank financial institutions that were insolvent due to holdings of distressed mortgage-backed securities.² The Fed's balance sheet as of May 3, 2023 totaled \$8.504 trillion,³ comprised of \$5.223 trillion in holdings of U.S. Treasury Securities (Treasuries)⁴ and \$2.576 trillion in mortgage-backed securities (MBS).⁵

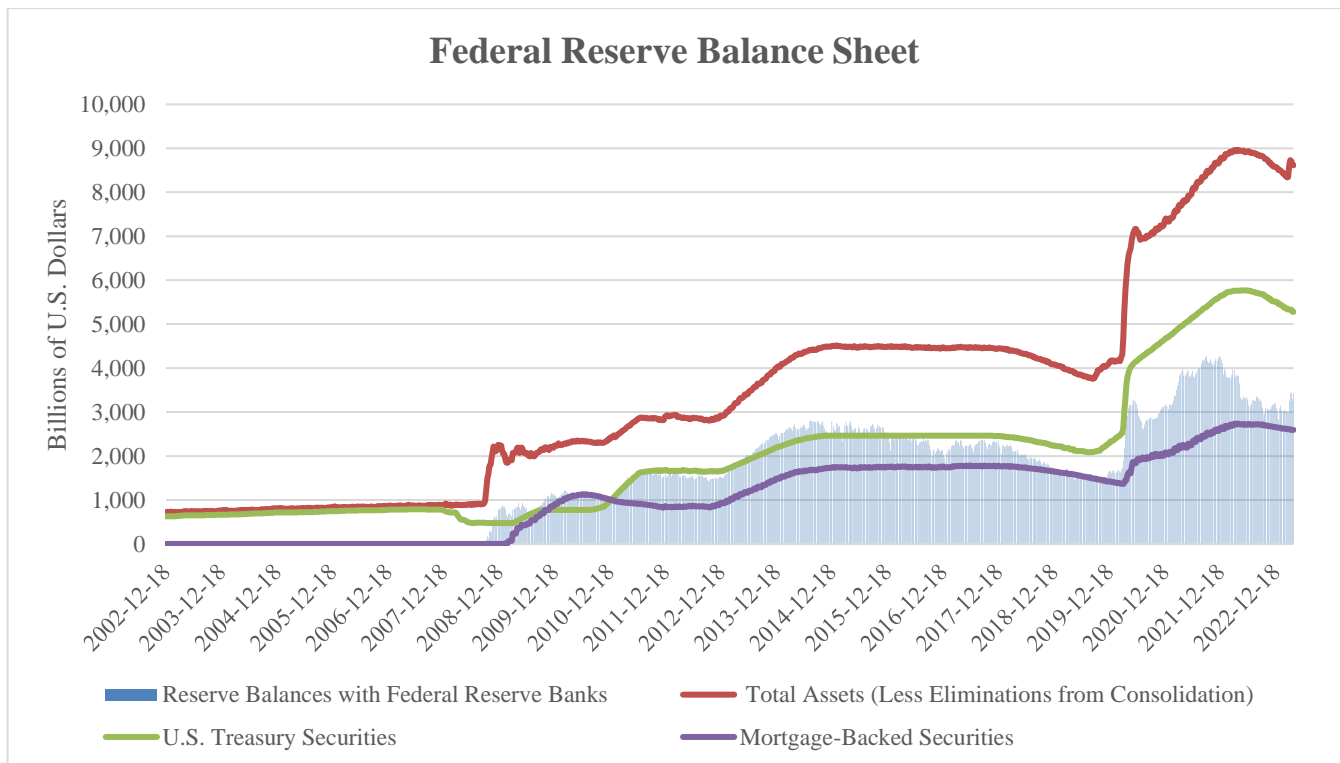


Figure 1⁶

- The substantial growth in the Fed's balance sheet since 2008 is largely a result of Congress giving it broad discretion to amend its operating structure that provides member banks a risk-free option to earn interest on reserves.⁷ This "floor system" has put strain on the Fed because of the increasing interest payments it must make on these reserves in a rising rate environment needed to combat inflation.⁸ The Fed's change in 2008 to implement a "floor system" and pay interest on reserves impedes the interbank lending in the federal funds market that provides a viable incentive mechanism for banks to monitor counterparty bank soundness,⁹ and has led the Fed to grow its balance sheet through increases in excess bank reserves.¹⁰
- The Fed's challenges in conducting responsible monetary policy in large part stem from the expanded scope of discretion and control in carrying out its triple mandate,¹¹ leading to moral hazard concerns given its expanded footprint over economic activity, influencing profits and losses of specific enterprises, favoring government over private investment, and transferring financial risks to taxpayers.^{12,13}
- **Fed suffers historic income losses as interest payments on reserves mount**
 - The Federal Reserve faces new ground as it is financially insolvent for the first time in its 108-year history.^{14,15} The Fed's embedded losses in its investment securities totaled more than \$1.2 trillion at year end 2022,¹⁶ which reflect unrealized losses on the estimated mark-to-market value of its holdings on balance sheet.¹⁷
 - The Fed has incurred net income losses and it is now in the red,¹⁸ and these ongoing income losses will soon total more than its stated equity capital of \$42 billion.¹⁹
 - The Fed's net income losses over the past year are largely a consequence from the mismatching in interest rates between its assets and liabilities.²⁰
 - As of May 3, 2023, earnings remittances due to the Treasury had decreased \$54.472 billion, with the suspension of remittance payments extending back to the week of September 7, 2022. The decline in interest income at the Federal Reserve could last several years.^{21,22}
 - The Fed's real equity capital deficit will worsen as operating losses persist, even though it can maintain its reporting of a positive equity capital position by using an accounting procedure that allows the bank to record accumulated losses as a deferred asset on its balance sheet.²³

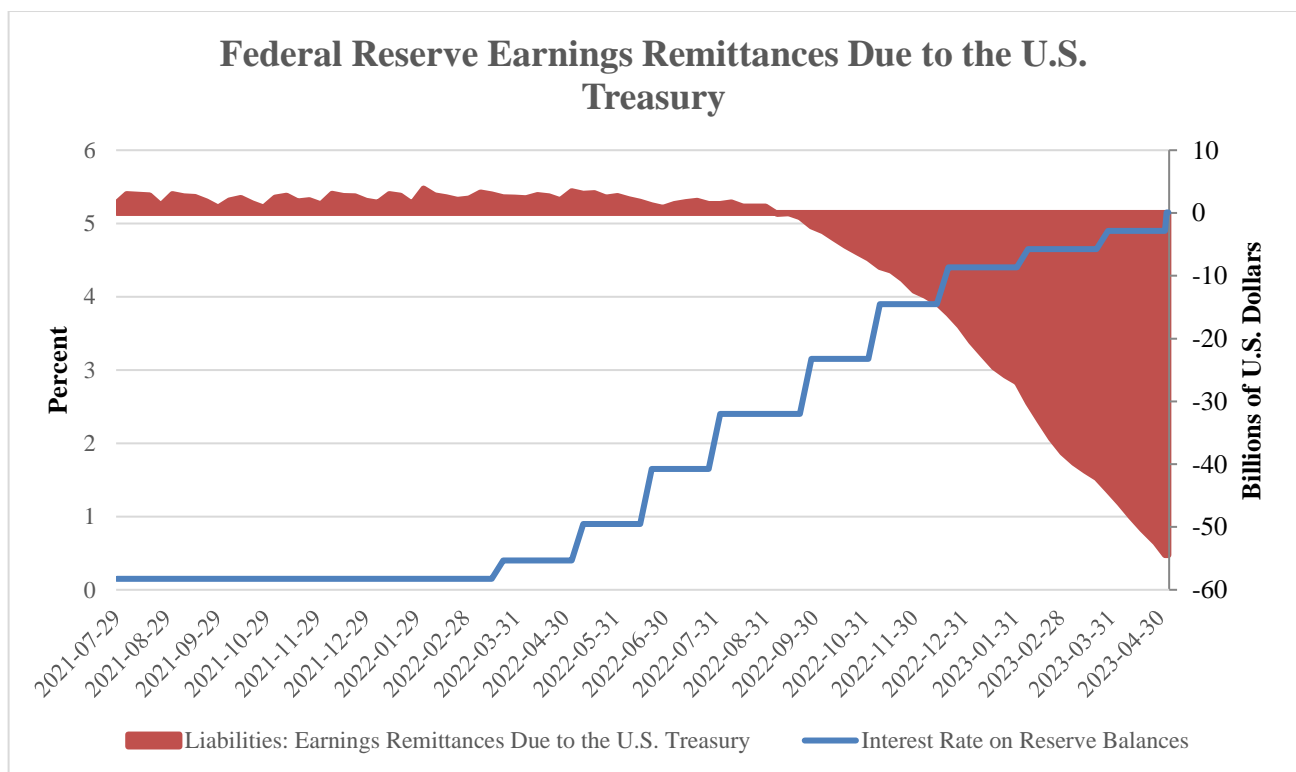


Figure 2²⁴

- The Fed has determined that it can use accounting gimmicks to hide losses as deferred assets on its balance sheet, which reflects an amount totaling the shortfall between earnings and expenses and an amount that will be repaid through future earnings without interest owed,²⁵ effectively monetizing any current financial balance sheet insolvency. While the Federal Reserve determined on its own to use the deferred asset accounting procedure to deal with bank losses, it is inconsistent with the statutory requirement under the Federal Reserve Act that Federal Reserve member banks be assessed to cover operating losses.²⁶ Congress did not authorize the uses of accounting procedures to record actual losses as positive capital and surplus position in member bank balance sheets, in effect creating the illusion of capital cushions.²⁷
 - The Fed treats one of its balance sheet liabilities differently and distinct from others: the accounting related to earnings remittances due to the Treasury. More than a decade ago, the Fed started using an accounting gimmick that recorded net income losses as a deferred asset on its balance sheet that reflects a decrease of future liability owed to the Treasury. In a 2011 Fed Statistical Release, the Federal Reserve Bank of New York recorded a deferred asset for the week of November 3, 2011. Until the past year, however, the Federal Reserve has not recorded a deferred asset of any significant size as it had never been the case that the Federal Reserve needed to suspend remittances to the Treasury.²⁸
 - The Fed is required to remit excess earnings to the Treasury among its net income (earnings) to the Treasury, income after expenses and dividends and allowing for surplus to be equated to capital paid in. Since September 2022, the Federal Reserve had a net negative consolidated income and suspended earnings remittances due the Treasury,²⁹ recording these shortfalls as deferred assets and representing future Fed liabilities (payments owed the Treasury at a later date).³⁰ See Figure 2.
- **Fed's financial losses add to our nation's fiscal pressures**
 - While the Federal Reserve does not incur all of the same risks faced of commercial banks (i.e., the Fed does not have to consider customer depository “flight” risks since it is the nation’s bank of first/last resort³¹), many are in concept the same portfolio risk such as losses stemming from liquidity risks, with any actualized losses absorbed by taxpayers.³²
 - When Congress authorized the establishment of the Federal Reserve system, district banks were restricted in its asset holdings and member bank reserves did not pay interest.³³ Today, the opposite situation occurs as member banks earn interest income by putting reserves at the Fed, a contributing factor for the net income shortfall.
 - When properly considered, losses incurred by the Federal Reserve increase the deficit and any sustained losses incurred by the Fed would be repaid by future taxes.
 - Any net income shortfalls incurred by Fed banks implicitly add to the federal deficit and marginally increase the borrowing needs of the federal government, since the central bank has elected to suspend remittances that would otherwise be paid to the Treasury from earnings, which the Fed will not resume until deferred assets on its balance sheet return to zero.³⁴
 - Thus, while the Federal Reserve can be balance sheet insolvent—its current financial status—federal taxpayers ultimately back any losses, with suspended remittance payments effectively contributing to growing fiscal deficits. The Fed also can print more money (create new reserves) to pay interest owed on outstanding reserves.³⁵
- **Fed's funding transfers to CFPB subvert Congressional appropriations**
 - The Federal Reserve has funded operating expenses of the CFPB through annual transfers, with total requested transfers totaling \$641.5 million, \$92.5 million less than the \$734 million annual transfer cap for fiscal year 2022. As specified in the Dodd-Frank Act, annual transfers may not exceed an amount equal to 12 percent of the Federal Reserve System’s total 2009 operating expenses, which is an amount adjusted annually based on the percentage increase in the employment cost index for total compensation for state and local government workers.³⁶ The 2010 Dodd-Frank Act, which authorized the establishment of the independent regulatory agency, provided the CFPB a funding mechanism through Federal Reserve transfers, funding that is not subject to annual Congressional appropriations.³⁷
 - The CFPB funding mechanism is problematic for numerous reasons. The Federal Reserve does not currently generate net positive earnings to cover its own operating expenses and any transfer funding.³⁸

Further, the constitutionality of the transfer funding carried out by the Fed to cover CFPB operating expenses was challenged in a U.S. Fifth Circuit Court decision that ruled it subverts the Congressional Appropriations process by violating the Appropriations Clause.³⁹ The U.S. Court of Appeals for the Second Circuit has since ruled the funding structure does not violate the Appropriations Clause.⁴⁰

POLICY SOLUTIONS

- Congress should pass the Federal Reserve Loss Transparency Act⁴¹ that would prohibit any transfers to the CFPB during any quarter that Federal Reserve banks incur operating losses.
- Congress should pass legislation such as the CFPB Transparency and Accountability Reform Act^{42,43} that amends the Consumer Financial Protection Act of 2010 and ensure the CFPB is subject to the regular appropriations process.
- Congress should repeal Title I of the Dodd-Frank Act that authorized a financial stability mandate for the Federal Reserve. In doing so, Congress should require that the Federal Reserve adhere to the 2006 Financial Services Regulatory Relief Act⁴⁴ that would cap the rate of interest that the Fed pays on reserve balances not to exceed “the general level of short-term interest rates.”⁴⁵

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¹ Board of Governors of the Federal Reserve System (US), Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/WALCL>

² Norbert J. Michel. Systemic Risk Regulation and the Myths of the 2008 Financial Crisis. Cato Institute. February 3, 2022.

<https://www.cato.org/briefing-paper/systemic-risk-regulation-myths-2008-financial-crisis>

³ <https://fred.stlouisfed.org/series/WALCL>

⁴ Board of Governors of the Federal Reserve System (US), Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/TREAST>

⁵ <https://fred.stlouisfed.org/series/WSHOMCB>

⁶ <https://fred.stlouisfed.org/series/WRESBAL>; see also, <https://fred.stlouisfed.org/series/WALCL>; and

<https://fred.stlouisfed.org/series/TREAST>; <https://fred.stlouisfed.org/series/WSHOMCB>

⁷ George Selgin. The Fed’s New Operating Framework: How We Got Here and Why We Shouldn’t Stay. Cato Journal. Spring/Summer 2019. <https://www.cato.org/cato-journal/spring/summer-2019/feds-new-operating-framework-how-we-got-here-why-we-shouldnt-stay>

⁸ The Fed in 2008 implemented the policy to pay interest on reserve balances (later excess reserves) that member banks keep at Fed district banks, which departed from the “corridor-type” system that the Fed had used prior to this change that involved the Fed influencing market interest rates by changing the available supply of bank reserves. *Id.*

⁹ The market today for interbank lending on unsecured federal funds is about a quarter of the size compared to the \$200 billion daily activity that occurred prior to 2008. There is also lending to banks that occurs by government-sponsored enterprises (GSEs), with funds the GSEs hold at the Fed without the ability to earn interest on reserve balances. *Id.*

¹⁰ *Id.*

¹¹ The Federal Reserve has a long-standing dual mandate to conduct monetary policy to maintain maximum employment and price stability. Further, under the 2010 Dodd-Frank Act, Congress provided the Fed with an additional financial stability mandate. Pub. L. 111-203.

<https://www.congress.gov/bill/111th-congress/house-bill/4173/text>

¹² George Selgin, William D. Lastrapes, and Lawrence H. White. Has the Fed been a failure? Journal of Macroeconomics. Vol. 3 (3) 2012.

<http://www.fte.org/wp-content/uploads/WhiteSelginLastrapesFed1.pdf>

¹³ George Selgin et al. Monetary Policy That Holds the Fed Accountable. Cato Institute. October 26, 2022.

<https://www.cato.org/publications/section-5-monetary-policy-holds-fed-accountable>

¹⁴ Paul H. Kupiec and Alex J. Pollock. For the First Time, the Fed is Losing Money. The Wall Street Journal. March 26, 2023.

<https://www.wsj.com/articles/for-the-first-time-the-fed-is-losing-money-mortgage-backed-securities-treasurys-interest-rate-risk-svb-ad92e96f>

¹⁵ In 1915 the district reserve banks did have combined negative earnings before dividends totaling \$141,000. Paul H. Kupiec and Alex J.

Pollock. Who Owns Federal Reserve Losses and How Will They Impact Monetary Policy. The American Enterprise Institute. June 2022.

<https://www.aei.org/wp-content/uploads/2022/06/Kupiec-Pollock-Who-Owns-Federal-Reserve-Losses-WP-1.pdf?x91208>

¹⁶ According to the last Federal Reserve financial report, for the period ending December 31, 2022, the net cumulative unrealized losses totaled \$1.208 trillion. Federal Reserve Banks Combined Quarterly Financial Report. Washington: Board of Governors of the Federal Reserve System. March 2023. <https://www.federalreserve.gov/aboutthefed/files/combinedfinstmt2022.pdf>

¹⁷ Alyssa Anderson, Dave Na, Bernd Schlusche, and Zeynep Senyuz. An Analysis of the Interest Rate Risk of the Federal Reserve’s Balance Sheet, Part 1: Background and Perspective. FEDS Notes. Washington: Board of Governors of the Federal Reserve System. July 15, 2022.

<https://www.federalreserve.gov/econres/notes/feds-notes/an-analysis-of-the-interest-rate-risk-of-the-federal-reserves-balance-sheet-part-1-20220715.html>

¹⁸ <https://www.aei.org/wp-content/uploads/2022/06/Kupiec-Pollock-Who-Owns-Federal-Reserve-Losses-WP-1.pdf?x91208>

¹⁹ Paul H. Kupiec and Alex J. Pollock. For the First Time, the Fed is Losing Money. The Wall Street Journal. March 26, 2023.

<https://www.wsj.com/articles/for-the-first-time-the-fed-is-losing-money-mortgage-backed-securities-treasurys-interest-rate-risk-svb-ad92e96f>

²⁰ Alex J. Pollock and Paul H. Kupiec. The Fed is in the red: Should it still pay CFPB’s bills? The Hill. October 26, 2022.

<https://thehill.com/opinion/finance/3705053-the-fed-is-in-the-red-should-it-still-pay-cfpbs-bills/>

²¹ Alyssa Anderson, Philippa Marks, Dave Na, Bernd Schlusche, and Zeynep Senyuz. An Analysis of the Interest Rate Risk of the Federal Reserve's Balance Sheet, Part 2: Projections under Alternative Interest Rate Path. FEDS Notes. Washington: Board of Governors of the Federal Reserve System. July 15, 2022. <https://www.federalreserve.gov/econres/notes/feds-notes/an-analysis-of-the-interest-rate-risk-of-the-federal-reserves-balance-sheet-part-2-20220715.html>

²² John H. Cochrane. Rate Hikes are Costing the Fed and the Treasury: A stubborn inflation could make things a lot worse. University of Chicago Booth Review. February 2, 2023. <https://www.chicagobooth.edu/review/rate-hikes-are-costing-fed-treasury>

²³ Paul H. Kupiec and Alex J. Pollock. Hemorrhaging losses, the Fed's problems are now the taxpayer's. The Hill. February 28, 2023. <https://thehill.com/opinion/finance/3877483-hemorrhaging-losses-the-feds-problems-are-now-the-taxpayers/>

²⁴ <https://fred.stlouisfed.org/series/IORB>; see also, <https://fred.stlouisfed.org/series/RESPLLOPNWW>

²⁵ <https://www.federalreserve.gov/pubs/feds/2013/201301/revision/201301pap.pdf>

²⁶ Paul H. Kupiec and Alex J. Pollock. Who owns the Fed's massive losses? The Hill. June 23, 2022.

<https://thehill.com/opinion/finance/3532683-who-owns-the-feds-massive-losses/>

²⁷ <https://www.aei.org/wp-content/uploads/2022/06/Kupiec-Pollock-Who-Owns-Federal-Reserve-Losses-WP-1.pdf?x91208>

²⁸ Federal Reserve Statistical Release. November 3, 2011. <https://www.federalreserve.gov/releases/h41/20111103/>

²⁹ Seth Carpenter, Jane Ihrig, Elizabeth Klee, Daniel Quinn, and Alexander Boote. The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections. International Journal of Central Banking. March 2015. <https://www.ijcb.org/journal/ijcb15q2a7.pdf>

³⁰ In 2022, the Federal Reserve's operational expenses, which include salaries, pension benefits, occupancy, and equipment, totaled \$5.6 billion, compared to \$102.4 billion in interest expenses. Markets Group of the Federal Reserve Bank of New York. A Report Prepared for the Federal Open Market Committee: Open Market Operations During 2022. Federal Reserve. April 2022.

<https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2022-pdf.pdf>

³¹ Norbert J. Michel. SVB Debacle Brings the Fed One Step Closer to Becoming Provider of First Resort. Cato Institute. March 23, 2023.

<https://www.cato.org/commentary/svb-debacle-brings-fed-one-step-closer-becoming-provider-first-resort>

³² The Federal Reserve does have a statutory requirement to avoid taking credit-related losses, as stipulated under Section 1101 of the Dodd-Frank Act. Paul H. Kupiec and Alex J. Pollock. For the First Time, the Fed is Losing Money. The Wall Street Journal. March 26, 2023.

<https://www.wsj.com/articles/for-the-first-time-the-fed-is-losing-money-mortgage-backed-securities-treasurys-interest-rate-risk-svb-ad92e96f>

³³ <https://www.aei.org/wp-content/uploads/2022/06/Kupiec-Pollock-Who-Owns-Federal-Reserve-Losses-WP-1.pdf?x91208>

³⁴ Andy Levin and Bill Nelson. The Federal Reserve's Balance Sheet: Costs to Taxpayers of Quantitative Easing. Mercatus Center at George Mason University. January 10, 2023. <https://www.mercatus.org/research/policy-briefs/federal-reserves-balance-sheet-costs-taxpayers>

³⁵ <https://www.chicagobooth.edu/review/rate-hikes-are-costing-fed-treasury>

³⁶ The annual transfer amount requested from the CFPB have increased from \$381 million in fiscal year 2018. Financial report of the Consumer Financial Protection Bureau. CFPB. November 15, 2022. https://files.consumerfinance.gov/f/documents/cfpb_financial-report_fy2022.pdf

³⁷ Politico Morning Money. The FDIC is also sweating the CFPB's Supreme Court case. February 28, 2023.

<https://www.politico.com/newsletters/morning-money/2023/02/28/the-fdic-is-also-sweating-the-cfpbs-supreme-court-case-00084688>

³⁸ <https://www.wsj.com/articles/for-the-first-time-the-fed-is-losing-money-mortgage-backed-securities-treasurys-interest-rate-risk-svb-ad92e96f>

³⁹ The U.S. Court of Appeals for the Second Circuit ruled the CFPB funding does not violate the Appropriations Clause, after the U.S. Fifth Circuit Court made this ruling of the CFPB funding mechanism, which would have applied to other independent federal agencies, including the Federal Deposit Insurance Corporation (FDIC). Sam Sutton. <https://www.politico.com/newsletters/morning-money/2023/02/28/the-fdic-is-also-sweating-the-cfpbs-supreme-court-case-00084688>

⁴⁰ Richard J. Andreano, Jr. John L. Culhane, Jr., Michael Gordon, and Alan S. Kaplinsky. Second Circuit rules CFPB's funding does not violate Appropriations Clause. Ballard Spahr. March 27, 2023. <https://www.consumerfinancemonitor.com/2023/03/27/second-circuit-rules-that-cfpbs-funding-does-not-violate-appropriations-clause/>

⁴¹ H.R. 8918 – Federal Reserve Loss Transparency Act. U.S. House of Representatives 118th Congress. <https://www.congress.gov/bill/117th-congress/house-bill/8918/text?s=1&r=7>

⁴² H.R. 2798 – CFPB Transparency and Accountability Reform Act. 118th Congress. <https://www.congress.gov/bill/118th-congress/house-bill/2798/text?s=1&r=2>

⁴³ Similar legislation has been introduced under the 117th Senate in S. 5280 – CFPB Stability Act of 2022.

<https://www.congress.gov/bill/117th-congress/senate-bill/5280?s=1&r=4>

⁴⁴ Pub. L. 109-351. <https://www.congress.gov/109/plaws/publ351/PLAW-109publ351.pdf>

⁴⁵ George Selgin et al. Monetary Policy That Holds the Fed Accountable. Cato Institute. October 26, 2022.

<https://www.cato.org/publications/section-5-monetary-policy-holds-fed-accountable>